5

DIVISION OF REVENUE

Introduction

Three spheres of government

The Constitution lays the foundation for a unitary but decentralised system of intergovernmental relations by providing for three “distinctive, interdependent and interrelated” spheres of government. The Constitution provides for expenditure and tax assignment and intergovernmental transfers. Section 214 of the Constitution stipulates that all revenue raised nationally be divided equitably between the three spheres. In addition to their equitable share, provincial and local governments also receive conditional or unconditional allocations from the national share. Conditional grants were first introduced in the 1998 Budget.

The Constitution also has some unique features pertinent to intergovernmental fiscal relations. This is underpinned by a commitment to basic human rights, set out in the Bill of Rights in Chapter 2, and to co-operative governance, spelled out in Chapter 3. The Bill of Rights sets the tone for the emphasis on the delivery of basic services to all South Africans, which impacts on the budgets of all three spheres of government. The commitment to co-operative governance has created an environment in which the intergovernmental system has evolved and responded to emerging needs. It has allowed a more collegial approach to problem solving and sharing of resources, encouraging consensus rather than conflict between the spheres.

Financial management

Financial management continues to improve in the nine provinces. Expenditure has been brought in line with available resources and budgetary processes are now more robust and transparent. The strong emphasis on co-operative governance and on laying sound foundations for intergovernmental relations is showing positive results, as evidenced by the improving fiscal position of the provinces and the increased number of beneficiaries of social services. Some progress has been made in improving local government finances, but the demarcation process and the transformation of local government continue to pose significant challenges.

The intergovernmental budget process

Guided by the Intergovernmental Fiscal Relations Act

The Intergovernmental Fiscal Relations Act of 1997 came into effect on 1 January 1998 and was first fully implemented for the 1999 Budget. The Act formalises an intergovernmental budget process. In terms of the Act, the Financial and Fiscal Commission (FFC) proposes a division of revenue ten months before the new financial year. This is submitted to the Minister of Finance, Parliament and the nine provincial legislatures. The Minister then consults the provinces, local government and the FFC before proposing a division of revenue for consideration by Cabinet.

Division of revenue bill

At the time of the Budget, the Minister tables a Division of Revenue Bill, setting out the final allocations to the three spheres and each of the provinces, as well as any conditions that apply. The Bill is accompanied by a memorandum explaining any assumptions and formulae used in determining the allocations, and how those allocations comply with constitutional requirements and take into account the recommendations of the FFC.

The division of revenue between the spheres

An evaluation of priorities

The equitable division of national revenue between the three spheres of government is not determined by a formula because it is a political judgement based on the relative priorities of the functions performed by each sphere. The 1999/00 division of revenue sought to protect the social services and basic service delivery despite the unanticipated slowdown in economic activity. In 2000/01, the revised economic projections afford Government an opportunity to give attention to national functions while still allowing increased growth in social services expenditure.

Own revenues

In accordance with the Constitution, provincial and local government own revenues are not included in the calculation of the equitable shares. Provincial own revenue has been steadily decreasing, falling from R4,3 billion in 1995/96 to an estimated R3,4 billion in 1998/99. Provincial own revenue sources are limited, mainly comprising fees for motor vehicle licences, gambling licences and hospital services. Local government collects revenues primarily from electricity and water charges, levies and property taxes.

Projected allocations

Revised economic projections, fiscal policy considerations and adjustments to the calculation of GDP have been discussed in earlier chapters. The revised budget framework provides for additional non-defence spending of R4,6 billion, and R6,5 billion above the MTEF 1999 Budget estimates over the next two years. Over half of this has been allocated to provincial government, underscoring Government’s commitment to social service delivery. The adjustments provide a significant growth in the share of resources allocated to local government.

Funding provincial priorities

Expenditure decisions made by provincial governments impact directly on the lives of citizens because provinces are responsible for more than 60 per cent of non-interest spending. More than 80 per cent of provincial budgets are spent on delivering social services. The increased allocation to the provincial sphere recognises the increasing demand for these services. Extending health services, broadening the social security net and improving the quality of education services are central goals of Government. In addition, the increased provincial allocation provides for other provincial priorities, including:

- the maintenance of social and economic infrastructure;
- improved financial systems to support implementation of the Public Finance Management Act;
- personnel management reforms and restructuring of the public service; and
- agricultural and rural development.

Funding local government

The small proportion of nationally collected revenue flowing to local government reflects the ability of local government to raise the bulk of its own revenue. Local government is the sphere of government closest to the people, and is responsible for delivering basic services and infrastructure to households. Local government is undergoing considerable transformation and restructuring through the demarcation process and other initiatives. The current system of local government has been transitional, governed by interim legislation. Policy work has been completed and will be presented to Cabinet shortly. The allocations to local government need to accommodate the powers and responsibilities of new local government structures and take into account the extension of municipal infrastructure and the provision of basic services to low-income households.

Improvements in conditions of service

Improvements in conditions of service are negotiated annually in the Public Sector Central Bargaining Chamber. When the negotiations are concluded funds are distributed to departments and provinces from the ICS vote on the national budget. These funds, however, only cover increases in basic salary and directly linked benefits. Increases in other benefits or arising from promotions must be met from departmental or provincial budgets. In addition, the transfer through the ICS vote only covers the initial increase – the future costs implied by these increases must also be funded from departmental and provincial budgets. These additional costs have exerted enormous pressure on provincial budgets.

Table 5.1: The vertical division

R million	1999/00 Revised	2000/01	2001/02	2002/03
		Medium term estimates		
National allocation[1]	71 715	77 429	82 739	87 207
Provincial allocation	96 357	102 770	108 403	113 507
Conditional grants[2]	*8 363*	*8 361*	*8 236*	*8 349*
Local government allocation[3]	2 519	2 830	3 030	3 233
Total to be shared	**170 591**	**183 029**	**194 172**	**203 948**
Changes from 1999 Budget				
National allocation	*1 722*	*4 669*	*6 485*	
Provincial allocation	*1 959*	*2 359*	*3 346*	
Local government allocation	*203*	*350*	*450*	

1. The national allocation excludes conditional grants to provinces and local government as these are spent at the provincial and local levels.
2. The conditional grants exclude R1 420 million allocated to provinces in 1999/00 as part of the Adjustments Estimate.
3. Excludes conditional grants, such as the municipal infrastructure programme and bus subsidies allocated from national departments.

Impact on provincial budgets

The Budget provided R3 billion for improvements in conditions of service for 1999/00 of which R2,1 billion was estimated to accrue to provinces. Based on the final wage settlement, provinces will receive R2,4 billion from the ICS vote this year out of a revised total of R3,3 billion. As part of the budget reform process and the development of a remuneration policy, the continued treatment of ICS as a conditional grant is being reviewed.

The provincial equitable shares

Division by formula

The distribution of the equitable share between provinces is done on the basis of a redistributive formula that takes into account the demographic and economic profiles of the provinces. The elements of the formula are not indicative budgets or guidelines as to how much should be spent on those functions. Rather, the components are weighted broadly in line with expenditure patterns to provide an indication of relative need.

Improved stability in allocations

An advantage of the MTEF process is that it increases the predictability of revenue flows to provinces to facilitate budget planning. Last year, the allocations to provinces had to be adjusted to incorporate the results of the census and to reflect changes to the structure such as the introduction of the backlog component. This year, no changes have been made to the structure and fewer data adjustments were necessary. The largest adjustment will flow from the higher than anticipated equitable share for the provincial sphere.

Table 5.2: Provincial equitable shares

R million	1999/00 Revised	2000/01	2001/02	2002/03
		Medium term estimates		
Eastern Cape	15 238	16 452	17 280	17 956
Free State	5 918	6 408	6 750	7 036
Gauteng	12 932	14 235	15 244	16 152
KwaZulu-Natal	17 166	18 894	20 233	21 435
Mpumalanga	5 790	6 423	6 931	7 398
Northern Cape	2 117	2 302	2 436	2 551
Northern Province	11 509	12 626	13 476	14 231
North West	7 405	8 009	8 427	8 773
Western Cape	8 499	9 059	9 390	9 625
Total	**86 573**	**94 408**	**100 167**	**105 158**

Note: The equitable share allocations exclude conditional grants but include estimated improvements in conditions of service.

Components of the formula

The provincial revenue-sharing formula is based on the demographic and economic profiles of the provinces. It comprises six components:

- an education share (41 per cent) based on the average size of the school-age population (ages 6–17) and the number of learners enrolled in public ordinary schools;
- a health share (19 per cent) based on the proportion of the population without access to medical aid funding;
- a social security component (17 per cent) based on the estimated number of people entitled to social security grants – the elderly, disabled and children – weighted using a poverty index derived from the 1995 Income and Expenditure Survey;
- a basic share (7 per cent) derived from each province's share of the total population of the country;
- a backlog component (3 per cent) based on the distribution of capital needs as captured in the schools register of needs, the audit of hospital facilities and the share of the rural population;
- an economic output share (8 per cent) based on the distribution of total remuneration in the country; and

- an institutional component (5 per cent) divided equally among the provinces.

Updating the formula

Data in the formula were adjusted to reflect new information in two instances. Updated remuneration data have been incorporated into the economic activity component. Second, the weighting of the social services components reflect expenditure on these services over a three year period. Based on the expenditure data reported in the *Intergovernmental Fiscal Review 1999,* the weights of the education and health components have been increased by one percentage point, with a balancing reduction in the weight of the basic share.

Table 5.3: Components of the formula

	Education	Health	Social security	Basic share	Backlog	Economic output	Institu-tional	Weighted average
Weights	**41%**	**19%**	**17%**	**7%**	**3%**	**8%**	**5%**	
Eastern Cape	18,5%	17,0%	19,6%	15,5%	20,7%	5,9%	11,1%	16,8%
Free State	6,3%	6,5%	7,1%	6,5%	5,6%	5,1%	11,1%	6,6%
Gauteng	12,3%	14,7%	13,9%	18,1%	5,0%	43,2%	11,1%	15,7%
KwaZulu-Natal	22,1%	21,7%	19,6%	20,7%	23,0%	18,9%	11,1%	20,7%
Mpumalanga	7,3%	7,2%	6,5%	6,9%	8,5%	4,7%	11,1%	7,1%
Northern Cape	1,9%	2,0%	2,2%	2,1%	1,3%	1,6%	11,1%	2,4%
Northern Province	15,7%	13,3%	13,7%	12,1%	22,9%	1,7%	11,1%	13,5%
North West	8,0%	8,6%	8,7%	8,3%	9,5%	5,1%	11,1%	8,2%
Western Cape	7,9%	8,9%	8,8%	9,7%	3,6%	13,7%	11,1%	8,9%
Total	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**	**100,0%**

Phasing

The equitable share formula has been phased in to avoid disruptions in provinces where the target shares differ substantially from the current allocation of resources. Last year, taking into account the impact of the final census data on the allocations, a five-year phasing period was employed beginning in 1998/99. The target date of 2003/04 will be retained, with the effect of reducing the phase-in period to four years, from 1999/00 to 2003/04.

Moving towards equity

The equitable share formula recognises that the provinces have different demographic and economic profiles, markedly different levels of economic development and significant variations in socio-economic circumstances. The levels of wealth or income within a province are important determinants of demand for social services, particularly primary health care, education and income support. The equitable share formula is accordingly redistributive, to assist provinces in providing a basic level of services for all South Africans.

Conditional grants to provinces

Purposes of grants

The primary purposes of conditional grants are to support compliance with national norms and standards, to compensate provinces for providing services that may extend beyond provincial boundaries and to enable national priorities to be adequately provided for in sub-national budgets. The conditional grants proposed over the MTEF period are summarised in table 5.4.

Table 5.4: Conditional grants to provinces

	1999/00	2000/01	2001/02	2002/03
R million	Revised	Medium term estimates		
Health				
Central hospitals	*3 075*	*3 112*	*3 221*	*3 350*
Training and research	*1 118*	*1 174*	*1 215*	*1 264*
Redistribution of specialised services	*165*	*176*	*182*	*189*
Hospital rehabilitation	*200*	*400*	*500*	*520*
Durban and Umtata Hospitals.	*400*	*273*	*103*	
Provincial Nutrition Programme	*796*	*582*	*582*	*582*
Finance supplementary	2 500	2 212	2 000	2000
Education				
Financial management and quality enhancement	*111*	*272*	*283*	*294*
Classroom backlogs	*13*			
Housing: Capacity building	10	10	10	10
State Expenditure	59	100	140	140
Welfare and population development	137	50	0	0
Labour	56	0	0	0
Sub-total	**8 639**	**8 361**	**8 236**	**8 349**
Projected underspending	-276	0	0	0
Total[1]	**8 363**	**8 361**	**8 236**	**8 349**

1. This table excludes the R1 420 million to be transferred to provinces in 1999/00 as part of the Adjustments Estimate.

Existing conditional grants are continually reviewed to assess whether the type of grant, and the conditions applied, support attainment of their objectives.

Principal grant programmes

A conditional grant is voted as expenditure in the national budget and is recorded as revenue in the provincial or local government accounts. The national department is responsible for monitoring compliance with the conditions of the grant, whereas the province is accountable for the actual expenditure of the funds. The incentive, therefore, lies with the provincial department to meet the conditions of the grant as efficiently as possible. The largest grants are:

- several health grants, including provision for specialised health services, hospital rehabilitation and construction, and provincial nutrition programmes. These grants totalled R5,7 billion for 1999/00;
- a supplementary allocation to augment provincial funding of social services and assist in improved financial management, managed by the Department of Finance; and
- a number of grants, totalling R191 million in 1999/00, spread across departments to improve financial management systems.

Converting agency payments

Agency payments are grants made to provinces and municipalities to re-imburse them for services provided on behalf of national government. Agency payments are not reflected on provincial or local budgets, and accountability rests with the national department. In the past, there has been some confusion surrounding the use and treatment of agency payments as opposed to conditional grants. Over time, national departments will be encouraged to convert agency payments into conditional grants with provincial and local governments being held accountable for both delivery of the service and management of the funds.

National–provincial fiscal relations

An evolving system

Intergovernmental fiscal relations have evolved rapidly over the past four years and will continue to do so, within the broad parameters of the Constitution and drawing on the advice of the Financial and Fiscal Commission.

Learning from international experience

International experience, particularly in developing countries, has shown that while fiscal decentralisation can offer significant gains under the right conditions it also carries the risk of accentuating inequities and compromising macroeconomic stability. Thus, establishing strong foundations and correctly sequencing the devolution of responsibilities is critical to attaining good governance. In developing a framework for intergovernmental fiscal relations, Government has been mindful of these considerations.

Commitment to co-operative governance

The principle of co-operative governance is articulated in Chapter 3 of the Constitution. A primary role of the institutions of co-operative governance is to align national policy goals and provincial budgets and planning.

Establishing intergovernmental institutions

Each of the relevant major departments has a MinMEC where national and provincial departments discuss policy issues. A MinMEC is a political forum consisting of the national Minister and the nine provincial MECs, supported by key departmental officials. For treasuries, the MinMEC – known as the Budget Council – was established in terms of the Intergovernmental Fiscal Relations Act. Joint MinMECs, where the Budget Council meets with other sectoral MinMECs, provide opportunities to review both budget and policy issues.

Extending sectoral co-ordination

Several technical committees (known as "4X4's") were established in 1998 to support the policy co-ordination process in the social services and provide inputs into the Budget Council and the Joint MinMECs. These deal with issues such as managing transformation, developing coherent policy within sectors and norms and standards for service delivery. They have met regularly and include representation from national and provincial treasuries and the line departments responsible for education, health and welfare. A transport technical committee was introduced this year, and similar processes are planned for public works and personnel. In addition to enhancing understanding of the impact of policy choices on budget decisions, these technical committees identify cost pressures within the key sectors and pursue innovative methods of improving service delivery without compromising the need for government to live within its means.

Allocations to local government

Equitable shares

The local government equitable share is the primary source of funding for poor and rural local governments. For the 2000/01 financial year, the local government allocation amounts to R2,8 billion. This represents an increase of R350 million over the original baseline allocation (see table 5.1). Several transitional arrangements impact on the actual allocation by formula. This includes historical factors, such as the phasing out of provincial management of former R293 towns and restructuring considerations. The Budget Forum is in the process of finalising an approach to guide the use of this allocation.

Distributing the equitable share

The formula for distributing the equitable share between municipalities comprises a municipal basic services transfer and a municipal institutional transfer. The basic services component enables poor municipalities to deliver basic municipal services to households while the institutional component provides support to those municipalities that lack administrative capacity and basic infrastructure. The current equitable formula is being reviewed to assess its impact on different sized municipalities and the extent to which it does benefit poorer households.

Other allocations

In addition to the equitable share, local government will receive a set of conditional grants aimed at providing infrastructure and subsidising commuter transport. The baseline allocations for these grants are reflected in table 5.5. These and other grants to local government will be finalised as part of the budgets of national departments. The table excludes grants for water infrastructure, estimated at R610 million for 1999/00.

Table 5.5: Baseline allocations to local government

R million	1999/00	2000/01	2001/02	2002/03
Municipal infrastructure programme	695	793	780	811
Bus subsidies	1 294	1 429	1 475	1 534
Land development objectives	38	44	46	47
Total	**2 027**	**2 266**	**2 301**	**2 392**

Conclusion

The division of revenue continues to support social services and provide for redistribution from richer to poorer areas of the country. Co-operative governance underpins intergovernmental fiscal relations, and is a cornerstone of improved financial management and budgeting in provincial and local government.